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"It is not so much the folly of the ordinary man who played the market during the stock exchange boom as the folly of those to whom he looked for advice and guidance which is most striking. In some cases of course this was more, or worse, than folly. Many of those who offered advice were personally interested in the continuation of the Bull Market."

The Great Slump, Capitalism in Crisis, Goronwy Rees
Weidenfeld & Nicolson, London 1970

Watching the turmoil in SE Asia and given the 10th anniversary of the global 1987 crash, we thought it befitting to review the two most famous stock market crashes of this century, 1929 and 1987, looking for possible lessons. We investigate in particular the question of why the 1929 crash had such devastating effects on the economy while the initially even worse 1987 crash left it virtually unscathed.

The disquieting answer lies in the distinction between an asset "bubble" and an overall "bubble economy". That is, crucial in determining the extent to which a stock market crash damages an economy and its financial system is the level of fragility of that economy owing to preceding excesses. Why did the Hong Kong crash have such wide-ranging impact? Because overheated and overvalued markets are vulnerable to any unpleasant surprise, wherever it originates.

The safest thing to say is that stock markets around the world will not see their recent peaks for many years to come. For some time, they will move sideways under great volatility. What then? Gradual decline or — sooner or later — devastating crash? We explain, why we regard a crash as inevitable.

THE INEVITABLE CRASH

As we proceed into the final months of 1997, the former steep uptrend in stock prices has given way to ever greater volatility. Little news triggers stunning market moves. Historically, this kind of action has been typical of approaching market tops. But, we suspect, there is more to it than meets the eye.

Above all, we see aggressive trading in the attempt to exploit wide swings which, essentially, tends to create these swings. This is a money game where trading dynamics overwhelm company-specific and economic fundamentals. It is played in particular by the proprietary desks of big commercial and investment banks and hedge funds. Apart from being under constant high pressure to make money under any circumstances, they possess immense firepower and computerized investment strategies that provide unprecedented leverage and ease of execution.

The recent rising volatility in the stock markets was not about the nervousness of the small investor, but about the aggressive trading of big investors and professional investors to manage and exploit any swing. For hedge fund speculators, bank proprietary traders or institutional money managers, this is a money game where trading dynamics overwhelm both company specifics and economic fundamentals. What we see are institutional players with immense firepower and computerized strategies that provide unprecedented leverage and ease of execution, all this associated with news manipulation.

World equity markets have been unravelling at a disconcerting pace. Now every trader and investor will

want answered one question: Was this just a strong correction, after which the markets will resume their multi-year uptrend, as they did after the crash of 1987?

Trying to answer this question, please don't take Hong Kong for the culprit. This global stock market bubble was waiting for the needle that would prick it. In turn, Hong Kong was victimized by the bursting of the bubbles in the region around it. The whole region was gripped in an orgy of financial excess and related economic maladjustments. Tremendous losses in the financial markets are cumulating in an explosion of bad loans to corporations and builders, ravaging the banking systems and creating the risk of a credit crunch. We doubt that the global investment community has fully taken into account the severity of the collapse going on in SE Asia. And Japan, too, is flirting with seriously deteriorating conditions.

Longer-term, the main threat to U.S. stocks is impending profit disappointments in general and in the high tech sector in particular. We increasingly focus on the high tech sector for two reasons: first, because it has been the leader in this bull run of the U.S. stock market; and second, because the distress and devaluation race in Asia will greatly intensify the capacity and profit troubles of this sector.

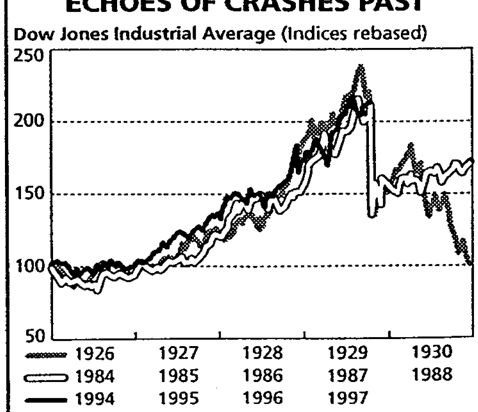
Collapsing PC prices, although to this point spurring demand, steers the industry on a collision course with collapsing profit margins and an eventual slackening of demand. Price cuts exceeding unit growth are the clear harbinger of growing profit woes. While American PC assemblers and consumers have benefited greatly from the collapse in memory and component prices, significant global overcapacity and SE Asian currency devaluations guarantee a vicious industry dog-fight.

Even the most ardent believers were temporarily shaken by a barrage of disappointments from market leaders, including Intel, Seagate, Xilinx, and Sun Microsystems. For a week, it looked very much like an inflection point. Intel lost a quick 11 percent, IBM 9 percent, Seagate 20 percent, Xilinx 18 percent, and Sun 15 percent while the NASDAQ 100 lost 5 percent and the semiconductor SOX index almost 11 percent. Texas Instruments, reporting stellar earnings and handily beating Wall Street expectations, nonetheless lost nearly 10 percent. Behemoth Taiwan Semiconductor, whose ADRs (American Deposit Receipt) had recently begun trading in New York, dropped almost 30 percent in five trading sessions as technology worries have become global.

WOULD A CRASH MATTER? ARE WE CLOSER TO 1929 OR TO 1987?

The recent 10th anniversary of the global stock market crash gave occasion to numerous reviews of the event. In general, the most favored observation was that the meltdown, though a lot worse than that in October 1929, had no visible impact on the U.S. economy and the world economy. Far from slowing, overall real GDP growth in the industrial countries even accelerated from 3.4 percent in 1987 to 4.4 percent in 1988. It made us curious to explore the causes of this tremendous difference in the economic impact of the two crashes, wondering at the same time, how the present-day global financial bull market compares in important aspects with those two periods.

ECHOES OF CRASHES PAST



Source: Datastream/ICV

Our approach starts with a distinction between "bubble" and "bubble economy". The term "bubble" simply marks an incongruous rise in certain asset prices relative to product prices, but without any effects on the economy. In Continental Europe, obviously inflated bond and stock prices have no apparent effect at all on consumer or investment spending. The term "bubble economy", on the other hand, designates an economy where surging asset prices overstimulate the economy or parts of it. Such a case was Japan in the late 1980s; such a case is the Asian Tiger countries, having to face now the dreadful after-effects, and such a case is presently the U.S. economy. Stupendous

wealth effects from soaring asset prices are the amphetamine that has been fueling unsustainable economic growth in general and consumer spending in particular, implying a later violent reversal.

Persistent monetary looseness with record-low short-term interest rates in major countries in conjunction with financial deregulation, innovation, globalization and breathtaking progress in the field of communication have been instrumental in creating a world financial system that creates money and credit for financial speculation without any limit. The results are grossly inflated financial activity and financial asset prices.

Outsized asset bubbles are rare events in history. But logic and the few actual incidents ought to put everybody, and central banks in particular, on alert against them as the most dangerous and potentially most harmful kind of inflation.

ASSET INFLATION ENJOYS POPULARITY

But what makes asset inflation so particularly dangerous and harmful?

The first and primary reason is that owing to its marvelous wealth effects it generally enjoys popular and official acquiescence. What's more, there is widespread general incomprehension. Looking for signs of inflation, all eyes are traditionally glued on consumer and producer price indexes as its only valid indicators.

Second, asset inflation overexpands balance sheets in general and those of the financial system in particular;

Third, it tends to feed into economic maladjustments, either through wealth effects into overconsumption or through artificially low capital costs into overinvestment.

Fourth, when the music stops, plunging asset prices disrupt balance sheets and debilitate the financial system. Each inflation is at first seductive but most seductive of all is asset inflation.

Asset bubbles developed in the postwar period first in the mid-1980s, engulfing mainly North America, the Nordic countries and England. They were concentrated, though, in real estate prices involving big malinvestments in commercial property. Punctured by tighter money, they all ended in credit-crunching mountains of bad loans. Yet, with the notable exception of Japan, significant financial debris was absorbed with a minimum of economic disruption.

At the time, the U.S. financial system went to the brink of disaster. With today's euphoria, this may seem like hyperbole. But think back to the early 1990s with the collapse of the junk bond market and Drexel Burnham; remember that Citicorp and other major money center banks looked destined to follow many other banks into insolvency; remember when it looked like California was following New England into a devastating real estate collapse. Instead, the risk of a financial collapse was recognized. The government and the Fed responded forcefully and successfully.

The Fed cut reserve requirements and slashed its federal funds rate to 3 percent, while the government pumped about $160 billion into the ailing S&Ls and the banking system through payments for deposit transfers from failing to healthy institutions. Moreover, the steeply rising yield curve propelled a bank stampede into an extremely profitable carry trade with Treasury securities. A booming stock market, powered by soaring mutual fund inflows, greatly assisted the recapitalization of the banking system through equity issuance. In the end, the U.S. economy escaped the near financial disaster with astounding ease.

HOW TO IDENTIFY A BUBBLE

In hindsight, it seems reasonable to wonder whether the crisis management at the time was not too successful. It appears that with its extremely loose monetary stance applied to contain the damage of the

bursting real estate bubble, the Fed steered straight into the next, much larger and comprehensive bubble — massive leveraged financial speculation embracing the whole world. Inadvertently, Mr. Greenspan had "put a coin in the fuse box". And, oh what a fuse box! It was Mr. Greenspan who years ago coined the "fuse box" analogy in his critical analysis of the speculative bubble of the late 1920s, at the time firmly pinning responsibility for it on the Federal Reserve's excessive monetary looseness.

Bubbles come in many shapes and sizes and happen under very different circumstances. But, like conventional inflation, they essentially reflect excessive money and credit creation. Its hallmark is credit expansion in excess of GDP growth. But for some reason or other the inflationary pressures burst out in the asset markets, rather than in the product markets. In the 1920s, U.S. stock prices more than trebled, whereas consumer prices remained perfectly stable. In the 1990s, stock prices have again trebled, as against a 30 percent rise in consumer prices.

The rampant inflation presently raging in the global financial markets is substantially of the same type as the U.S. brand of the 1920s. It is concentrated in bonds and stocks, but the valuation excesses and their global extension are without parallel. Never have so many financial markets around the world moved in lockstep to such unprecedented highs. On the other hand, consumer and producer price inflation have been falling around the world to postwar lows.

The difficulties in identifying a bubble is a favorite excuse for letting it run to extremes. It is a very poor excuse. By definition, a "bubble" consists of inflated asset prices. But how can it be determined whether or not asset prices are "inflated"? Is there any reliable measuring rod? To this question, the old economists would have replied: Yes, there is. Just check the sources of the money flowing into the markets. What makes a "bubble" are money flows from inflationary sources out of all proportion to economic activity and available current savings.

"The money sloshing around in world financial markets is completely out of control and absurdly in excess of available savings."

For these economists, the great divide was between two separate sources of investible funds. The first is current savings. The other is "inflation" in the widest sense of the word, deriving from credit creation or from a mass movement out of cash and into securities.

Now about 90 percent of world capital flows is financial investment and speculation. There is an estimated $3 trillion of hot money unregulated offshore, which is relentlessly circulating in search of a quick profit. The United States had last year capital inflows of $547 billion and capital outflows of $352 billion — altogether $899 billion. To be sure, these torrential flows, in and out, were ludicrously out of whack with available savings. Huge inflows into Treasuries actually came overwhelmingly from central banks and tax havens, reflecting the carry trade of U.S. hedge funds. Recently, the Wall Street Journal reported of one person on the Soros team, holding a position of $57 billion, with only $2.4 billion equity. Be sure that even the minimal equity did not come from current savings.

Or take Germany as another example. So far this year, net bond issues are running at an annual rate of DM 350 billion, far in excess of available domestic savings. Yet long-term rates are declining. And who are the buyers? Banks took 54 percent (adding to the money supply); foreigners 40 percent, no doubt largely carry trade. Personal and institutional investors bought a stingy 6 percent of total net issues. Bond markets are now completely in the hands of heavily leveraged traders and speculators.

Checking in this way the capital accounts of one country after the other one, it becomes manifest that the money sloshing around in world financial markets is completely out of control and absurdly in excess of available savings.

WHY MONEY FLOWS CHANGED DIRECTION

But why this persistent diversion of money flows into the financial markets? The short answer is that there are two outlets for money and credit: economic activity and existing capital assets and all sorts of paper property. In actual fact, the coexistence of sluggish economies and booming financial markets is nothing new. It has been the regular, typical pattern in times of recession. But never has this dichotomy lasted so long. But why? In short, because economic sluggishness is among the industrial countries no longer cyclical and short-term. It has become structural and long-term, and along with prolonged economic weakness came prolonged monetary looseness. However, instead of stimulating their economies, central banks are overstimulating financial speculation, and the longer these low interest rates ruled, the greater their effect on expectations. That is the salient point to see.

But what is it that has, to all appearances, lastingly impaired the vigor of our economies? In brief, structural maladjustments inflicted by decades of bad policies (monetary, fiscal and wage) which everywhere have one common denominator: a relentless rise in public and/or private consumption at the expense of savings and investments. In Austrian theory: capital consumption.

In step with this structural break of the economies went profound changes in the financial system. Overabundant, cheap liquidity unleashed cut-throat competition for lending. As the costs of financing provided through ultra-cheap money markets and booming securities markets drastically fell, the profit margins in the banks' traditional businesses drastically eroded.

Faced with this profit calamity, banks and other financial institutions boosted credit volume through lowering their lending standards or by aggressively stepping up their activity in the financial markets. With sharply increased proprietary trading, they went for capital gains. And with the promotion of customer trading in the financial markets, they went for much greater fee income from this source. To this end, a tremendous institutional infrastructure has been built up to foster fee-producing churning action.

THE U.S. CASE — NEW ERA OR BUBBLE?

As to the economic situation, the only economy still perceived as healthy and strong is the U.S. economy. We have often enough expressed our disagreement. What we see is the unsustainable vitality of a bubble economy, that is an economy which is driven but also maladjusted by asset inflation. A major contributor to the U.S. economy's recent acceleration has been a personal consumption binge, apparently fueled by the huge stock market wealth effects. Its corollary is a new low of the personal savings rate of just 3.6 percent.

If the booming stock market and its rosy side effects hold up, the economy might remain strong for a while. Further economic strength, though, would trigger interest rate fears or Fed tightening while slowing growth would squeeze already declining profit margins. Either outcome would seriously impinge on the bull market.

It is our long-held view that the U.S. economy is vulnerable to a shake-up of the preposterously overvalued stock market, primarily owing to multiplying profit disappointments. Yet the greatest dangers may lurk in the overextended financial system as a whole, where considerations of financial sanity and quality have gone completely by the wayside. As market financing has exploded, market psychology and confidence acquire a growing role. This is true on the upside and, even more, on the downside. Central banks may act as lender of last resort to banks but in the vast securities markets, they have very limited power.

If you believe Prof. Milton Friedman, the Great Depression of the 1930s was caused by blundering monetary policy after the crash: specifically, that the Fed allowed the development of the banking crisis by implementing a vehement contraction of the money supply. This was crucial, says Friedman, because this was the mechanism which produced the money contraction. In other words, changes in the money supply come about by increased or decreased bank lending or investments.

With an eye on what is happening today, we regard such a unilateral focus on banks and money supply as far too simplistic, considering above all that in the 1920s nonbank financing — through the securities markets and the call money market — was almost four times the volume of bank financing. Given this heavy reliance on market financing rather than bank financing, it appears coherent that the abrupt disruption in those markets essentially had disastrous consequences for the economy as whole, regardless of what happened to the money stock. We are aware of course that, by definition, any assets other than money assets rank as illiquid. Taking this literally, it leads to the absurd presumption that soaring or plunging stock or bond prices have zero liquidity effect. In the real world, to be sure, the owner of assets in booming markets perceives these as being for himself perfectly liquid. What counts in this respect is perception, right or wrong, not terminology.

Now, comparing the losses in the 1930s banking crisis with the losses in the collapsing securities markets, there can be no doubt that the latter were the predominant cause of the following depression. Yet these implications are the least examined and least understood aspect of the proceedings at the time. It happens to be the aspect in which we see the most ominous parallels to the present. But to appreciate this, we need a clear sight of what preceded the crash and the depression.

THE NEW ERA OF THE 1920s

When in 1927-29 Wall Street zoomed and the economy boomed, the bulls invented the term "New Era". It meant to say that miraculous improvements in the economy warranted much higher stock prices than in the past and also their lasting rise.

Indeed, the U.S. economy had performed magnificently. The most striking features were persistent zero inflation, fabulous productivity growth in manufacturing (catchword "Industrial Revolution"), and a strong trade balance. Labor costs fell steadily, as wages rose less than productivity. Thus price stability went easily together with rising profit margins. In short, it was precisely the scenario of which Wall Street is today dreaming.

More than anything else, it was the prolonged price stability that stoked the bullish spirits. It was regarded as the acid test of extraordinary economic health. The most influential apostle of a "New Era" was Prof. Irving Fisher. He favored easy money and credit expansion as long as price inflation was absent. Moreover, he had great faith in the Fed's ability to fend off any threatening crisis. It was this fallacious notion of price stability as the hallmark of economic health that threw everybody off-guard.

As price stability was seen to assure prolonged monetary ease, it played a key role in sparking reckless financial speculation. Financing and overfinancing the developing speculative mania, money and credit flooded the financial markets out of all proportion to economic activity, in particular after Fed easing in the summer of 1927. Fleeing the low-yielding bank deposits, investors stampeded into bonds and stocks while corporations switched their financing from banks to the securities markets. Actually, doing so vastly in excess of their business requirements, they piled up huge cash surpluses, turning from biggest bank debtor to biggest bank creditor.

"It was this fallacious notion of price stability as the hallmark of economic health that threw everybody off-guard."

Money poured into the markets from two sources: from bank and broker loans financing margin buying of securities and from a simultaneous run out of money balances and into securities. As the corporations on their part were massively shifting their funding from the banking system to the markets, the banks, in turn, shoveled ample credit at investors and speculators, which used the money to buy securities at rising prices. According to a study published in 1931 by the United Nations, no less than 86 percent of bank lending went into the securities market. This, and not the high productivity growth or the low inflation, was the obvious chief propellant of the surging stock prices.

In a review of U.S. monetary policy, the chief economist of the Federal Reserve at the time wrote about

this episode: "What followed our easing was not, as might have been expected, a commodity price inflation, but a growth of speculation in securities and real estate, which helped bring about the collapse of 1929 and the depression of the 1930s. No country profited by that; on the contrary, the entire world suffered from the disastrous deflation which followed."

Still, in contrast to present complacency, leading bankers and Fed officials worried about the boom and its consequences. Alarmed about the bullish effects of its prior monetary easing on the markets, the Fed quickly reversed course again, despite continuous zero product inflation. Having cut its discount rate in August 1927 to 3.5 percent, the New York Fed raised it successively to 5 percent in July. Call money rates soared in March 1929 to a high of 20 percent. By past experience, this was a drastic tightening that would normally have stopped both the economy and the stock market boom. Yet, the stock market boom went on for a few more months, owing to its own momentum. Finally, in September, it began to falter.

OVERALL FINANCIAL CRISIS VERSUS BANKING CRISIS

According to Milton Friedman, the bank failures imposed losses totaling about $2.5 billion on bank stockholders, depositors and other creditors of more than 9,000 banks that suspended operations during the four years from 1930 through 1933, of which slightly more than half fell on depositors. By comparison, over the same four years, stock market losses are estimated to have amounted to about $85 billion, virtually equivalent to total GDP. Other major victims were holders of low-grade bonds, which went on to default or plunge in price.

True, commercial bank deposits were to fall by more than 42 percent, but their steep decline did not start before mid-1931, when the depression was already in full swing. In this light, we have always tended to concur very much with Prof. Kindleberger's verdict in his book about the causes of the Depression: "The danger posed by the market was not inherent in the level of stock prices and turnover so much as in the precarious credit mechanism which supported it." The price earnings ratio was modest compared with today. It had risen from a low of 9.8 in May 1927 to a peak of 16.2 in January 1929. This compares with 23 times earnings for the S&P500 today and 60 times earnings for the 100 largest NASDAQ stocks, mainly technological companies, and 35 times earnings for the small cap Russel 2000.

Not quite so self-evident is the unusual severity of the following depression. In this respect, a comparison with the effects of an earthquake come to mind. They are, in part, a function of the strength of the shocks and, in part, a function of the strength of the buildings affected. Reason suggests that the stock market crash of 1929 broke into an exceptionally fragile financial, banking, and general economic structure. As to the latter, there had been an inflationary overexpansion in industrial and agricultural capacity and in debt-financed consumption. Yet, the shutdown of the financial markets plus the tremendous wealth destruction appears to have been the most important single factor.

In the last analysis, just one little thing makes all the difference between a bull and bear market: a rise in liquidity preference, triggered either by a random event or, more often, by monetary tightening. What's new today is that for the first time ever the central bankers readily keep their money spigots wide open at low short-term interest rates upon which the speculators can run up their bubble of borrowing and buying financial assets. The general belief that their acquiescence has no limit is, of course, the crucial, great presumption behind the mania. Essentially, it makes any timing of the inevitable crash impossible.

THE INEVITABILITY OF THE CRASH

Why inevitable? Over time, the frenzied speculation completely detaches from economic reality. Asset prices rise and rise, not because they reflect correspondingly higher earnings but because the buyers expect to

sell their stocks or bonds — sooner or later — to a "greater fool" at an even higher price. Yet the reversal of this expectation at some point is inevitable either because of some seemingly disturbing event, for example profit disappointments, or merely because the markets run out of "greater fools". But whatever the reason (and it is really unimportant), one thing is absolutely certain: bubbles never end with a whimper but in a violent bust. This is inherent in the money mechanism.

The bust is inevitable because the financial system works asymmetrically in boom and bust. On the upside, during the boom, it is virtually infinitely elastic as many avenues of monetary expansion open up. That is, given rising asset prices, the flow of money into the markets is easily augmented by borrowing from banks or in the international repo market. But once the crowd wants to raise liquidity, the financial system turns completely unyielding. The salient point is that any investor desiring to become more liquid has to find a buyer who takes his place in the bubble. Collectively, investors and speculators are unable to exit. There is no new money available. It's a one-way street. All that a rush to sell achieves is collapsing market values without any increase in the money supply.

"A highly leveraged financial system has devastating implosive power."

Depending on the size of the bubble, any scramble for liquidity, therefore, tends to degenerate into panic as everybody's effort to raise his own liquidity by selling securities has no other effect than to destroy their value. The salient thing to see is that a highly leveraged financial system has devastating implosive power.

The "New Era" apostles of the 1920s proved horribly wrong. With the current bull market even longer and stronger, the question must be whether another similar crash is possible.In a way, the experience of 1987 is encouraging. Ten years ago, the Dow Jones lost a record 508 points or 22 percent, eliminating in one day $600 billion of financial wealth. In only 12 trading days, the S&P fell 34 percent. Most tech stocks, led by IBM and Microsoft, fell in half from their October peak. A 22 percent drop today would slash 1,800 points from the Dow, with a wealth evaporation of $2.2 trillion.

Overall, the stock market massacre of 1987 was worse than that of October 1929, but in striking contrast, it did no damage to the economy or the financial system. Why? Was it the genius of Mr. Greenspan? Does this mean that we can relax and safely trust the vigilance and custody of our central bankers in general and Mr. Greenspan in particular? My answer is a categorical No.

What radically differed in October 1987 from October 1929 was the absence of major economic and financial excesses. The excess in the stock market was in fact the only one, actually invoking two threats. The one was a widespread failure of broker customers to meet margin calls, and the other was that panic selling simply overwhelmed buying, in particular in the futures market. Thus, the rout was on. The first problem was solved, under pressure from the Fed, by an increase in bank loans to brokers by $7.7 billion.

One obvious key problem of the stock market had been plunging bond prices. Before the crash, between May and October, T-Bond prices had dropped 25 percent, while stock prices had over the year risen 40 percent. Against the background of strong economic growth of 5 percent at an annual rate, short-term interest rates had soared from 5 to 8 percent. With Paul Volcker still at the helm, money had been tight.

THE CRUCIAL DIFFERENCE BETWEEN 1929 AND 1987

What in 1987 crucially differed from 1929 was the stability and viability of the economy and the financial system. The 1929 crash had such devastating effects because it broke into an extremely unbalanced economic and financial structure Market financing instantly froze. The 1987 crash, in contrast, did hit a resilient economy and financial system. Actually, bond prices rallied ten points, shedding one full percentage point of yield.

More food for thought about the future gives the second trouble spot in the crash of 1987. It concerns the collapse of the stock index futures market. It dramatically proved that the futures and derivatives markets are in time of turbulence and panic more probably a source of trouble than of safety. What tremendously worsened the crash of 1987 was Wall Street's own creation — portfolio insurance, a strategy to protect stock portfolios against market falls. Rather than sell stocks as they decline, portfolio insurers were to sell stock-index futures contracts. If stocks continue to fall, the losses were to be cushioned by rising value of the futures position.

True, it insures against loss, unless everyone else wants to buy such insurance. As the futures selling quickly crushed futures buying, their prices plunged to heavy discounts relative to the stocks that make up the indexes. In theory, this was supposed to trigger heavy futures buying by arbitrageurs. But in the panic that developed, this failed to happen. Instead, frightened portfolio insurers stepped up their selling at the higher prices of the cash market accelerating of course the declines there. A strategy meant to limit losses had the opposite effect of actually precipitating the fall of the stocks. Market liquidity just disappeared. Even the biggest stocks simply stopped being traded.

THE MIRACLE OF OCTOBER 20, 1987

At noon, on Tuesday, with the closing of the Big Board seemingly imminent and the market in disarray, with virtually all futures and options trading halted, something happened that some later described as a miracle. In the space of five or six minutes, the Major Market Index (MMI) futures contract, a surrogate for the DJI and the only major index still trading, staged a most powerful rally, rising on the Chicago Board of Trade from a discount of nearly 60 points to a premium of about 12 points. Because each point represents about five in the DJI average, it was the equivalent of a 360-point rise in the Dow.

By forcing the futures contract rapidly to a premium, a relatively small amount exerted in the extremely thin market an enormous and disproportionate upward thrust as it triggered multiple buying of the stocks underlying the index. It remains a mystery, whether this action was spontaneous or a deliberate manipulation, but it saved a market that was on the brink of total collapse.

Actually, the index buying that turned the market was unbelievably small. According to statistics supplied by the Board of Trade, during the decisive half hour that encompassed the extraordinary rally — from 11.30 a.m. to noon in Chicago — only 808 contracts traded, representing an underlying cash value of the index of about $60 million. While in this case, it helped to prevent disaster, it also makes one wonder about the potential for manipulation in this market.

THE LESSON OF 1987 FOR TODAY

We have described the 1987 crash in some detail because it taught a different lesson than the 1929 crash — the lesson, namely, that sophisticated futures and derivatives markets have increased the vulnerability of the financial markets to a precipitous rush of investors and speculators for safety or liquidity. By contrast, the crash of 1929 disclosed broader weaknesses and imbalances in the U.S. economy and its financial system as a whole At that time, it was a seriously maladjusted bubble economy.

How does the present compare with these two examples? We think, there is today an uncanny accumulation of both kinds of problems. Stock prices are even more overvalued while financial excesses and the maladjustments in the economy are very much the mirror image of the buildup to 1929. Altogether, this warns of a probable repeat of the 1987 disaster in the futures and derivatives market but with much greater damage to the economy.

While in 1987 hedging against stock market losses revolved around the futures market, such strategies

predominate today in the unregulated over-the-counter derivative market with instruments, largely options, provided by commercial banks and investment banks. In the absence of any severe accident, they have been making big profits in this business. But one who remembers 1987 can only wonder what these banks and investment bankers will do when they are all of a sudden confronted with exploding demand for protection against losses.

What will they do? Run for cover, of course, and hedge their own exposure by shorting the underlying stocks on which they have written and sold their options — and thus exacerbate the crash, just as portfolio insurance did in 1987. The mere idea that a limited group of banks and investment bankers is able to provide insurance in a $10 trillion market is ridiculous.

DROWNING IN LIQUIDITY

Looking now at the U.S. economy, we see a financial system that is firing on all cylinders. Third quarter issuance of new debt and equity was a record $343 billion, a stunning 60 percent increase from a year ago. Wherever one looks, nothing but new records: mortgage-backed securities, junk bond issuance, common stock issuance, stock buy-backs. Through the third quarter, merger and acquisition announcements totaled already $640 billion, as against $649 billion in all of 1996 and $514 billion in 1995. As a sign of overheated equity prices, 43 percent of the deals are done with stock, in comparison to 7 percent in 1988. Today's takeovers have on average a P/E ratio of 33.9 compared to 23.3 at the top of the 1980s takeover boom.

"The 1987 experience ought to be taken as a warning of how fast market liquidity can vanish, not despite sophisticated market techniques but because of them."

Weighing these numbers, please keep in mind that economic growth, as measured by GDP, was at best around $100 billion in the third quarter. Today's markets are not only awash in liquidity, they are drowning in it, fueling frantic financial activity completely detached from economic activity. Earlier, we have explained why these floods of money concentrate on the financial sphere. That's where the big and quick profits are made — so far. But couldn't this vast excess of liquidity one day spill over into the economy, causing rampant inflation in consumer and producer prices?

Forget it. No chance.

There is but one single possible outcome for rampant asset inflation: complementary asset deflation. Taken as a whole, as explained earlier, the capital is definitely locked into the bubble. Any general attempt to exit it only hammers valuations. In this respect, the 1987 experience ought to be taken as a warning of how fast market liquidity can vanish, not despite sophisticated market techniques but because of them.

It is argued that market techniques have improved. Maybe, but market capitalization has meanwhile more than quadrupled. Given moreover the fact that the put options for portfolio insurance are today provided by commercial and investment banks at their risk, we can only wonder about their exposure in case of a crash. Just as in the 1920s, the commercial and investment banks are heavily involved in driving the dizzying spiral of share prices. What's even worse, they act as market-makers.

After all, we think, there is potential for a true crash. In the end, much will depend on its effects on the economy. As we have repeatedly explained, we regard the U.S. economy of today as severely unbalanced and, therefore, highly vulnerable to a financial crash. But for clarification, we stress our point: the crash is inevitable. Its timing, though, still remains in the dark.

CRASH IN SE ASIA

In its recently released World Economic Outlook, the International Monetary Fund says on its first page: "The current world economic expansion can be sustained, possibly into the next decade. There are relatively

few signs of the tensions and imbalances that have usually presaged significant downturns in the business cycle." What about the SE Asian countries? Yes, they had strong growth and fairly low inflation rates, yet they were riddled with gross imbalances.

For the time being, there seems to be no end to the vicious spiral of declining currencies, rising domestic interest rates, weakening growth prospects and collapsing stock markets in SE Asia since Thailand went on July 2 off its peg to a dollar-dominated basket of currencies.

Within just two to three months, an apparent economic miracle plunged into disaster. For more than a year, we have been warning of the SE Asian bubble.

SE ASIAN BUBBLE BURSTS

	Stock market % off 52-wk high local terms	Currencies YTD % change vs. USD	Stock markets YTD % change (in USD)
Thailand	-54%	-34%	-63%
Indonesia	-40%	-35%	-54%
Malaysia	-49%	-26%	-61%
Hong Kong	-45%	0%	-33%
Korea	-50%	-10%	-33%
Philippines	-30%	-34%	-59%
Taiwan	-35%	-10%	-32%
Singapore	-30%	-11%	-40%

**as of October 28, 1997*

It was sensible to let the overvalued currencies float downward. In general, this was meant to avoid steep rises in interest rates. They have soared nevertheless. Whether Asia will bounce back or lapse into financial and economic malaise will equally depend on appropriate domestic policies and favorable external conditions, such as global economic and trade growth, the competitive position of China, and on developments in the international capital markets. We are wary on all these fronts.

The imbalances in the economies, consisting of a glut of property and manufacturing plant, crushing unhedged foreign-denominated debts of banks and corporations (dollars, yen, Swiss francs), systemically weak financial systems overloaded with bad loans, and large current-account deficits, make altogether a potentially highly implosive mix, in particular if inept and blundering policies are added to the woes.

The severity of this crisis is only slowly sinking in. Taiwanese stocks, having posted strong gains throughout the summer successfully ignoring the SE Asian malaise, are now down 30 percent from their August record highs. Actually, Taiwan is recognized as the healthiest of the Asian economies, with $90 billion of currency reserves, an economy growing at 6 percent, low inflation and a current-account surplus. However, after spending nearly $5 billion of reserves and instigating tight monetary policies to defend its currency against capital flight, the authorities decided to let the Taiwan dollar float. In three trading sessions, it fell almost 10 percent. While this decline appears modest compared to the 30 to 40 percent plunges registered by Thailand, Indonesia, Malaysia and the Philippines, it is an ominous development. It was apparently understood that defending the currency by depleting reserves and choking the economy with high interest rates was likely futile and self-defeating.

Regional currency and economic concerns have also battered Hong Kong. After hitting record highs, equity prices have lost more than a quarter of their value. Red Chips, Chinese-affiliated companies trading in Hong Kong, are in a free-fall after a wild speculative run over the summer. With short-term interest rates above 9 percent, property and bank shares are under intense pressure as fears rise of an impending bursting of the overheated real estate bubble. Furthermore, a stable Hong Kong dollar can no longer be taken for granted. While the Hong Kong and Chinese authorities — with more than $200 billion of reserves — undoubtedly possess the ammunition for a successful defense of the Hong Kong currency — it seems reasonable to question their will to do so in an environment now overwhelmed with capital flight and competitive devaluations.

In traditional complacency, there was all too soon talk of bottom-fishing in the currencies and stock markets. Regular tranquilizers have been references to the excellent fundamentals of these countries which, in time, would reassert themselves. But bubbles tend to destroy the best fundamentals — see Japan. Given their

current-account deficits and high levels of foreign debts, the Asian Tiger countries are definitely in for far greater trouble than Japan.

Many Wall Street notables quickly weighed in on the Asian situation, discarding it as a minor, if not minimal, problem or even as "good for U.S. financial assets". None of them, though, had given forewarning. Among the industrial countries, Japanese and U.S. corporations and trade are most affected. Growing trade friction is looming.

CONCLUSIONS:

We repeat: asset bubbles never end with a whimper but with a bang. The bursting of the SE Asian bubble was long overdue. What's worse, they all are "bubble economies" in the sense that the soaring stock and property prices have severely unbalanced the economies and the financial systems by overstimulating building and industrial investment. Brace for far worse economic and financial repercussions than in Japan.

The fact that the crash in Hong Kong had such devastating effects on stock markets around the world reveals in the first place inordinate vulnerability and nervousness in the markets. Responsible for the increasing volatility is not the amateur investor who naïvely believes in a long-run uptrend but the institutional investors and proprietary traders of the banks, who distinguish themselves equally by aggressiveness and itchiness.

It appears now compelling that the global upward momentum in the stock markets has definitely been broken, But in markets where future returns depend overwhelmingly on continuous substantial capital gains, mere volatility is the beginning of the end. As the expected capital gains fail to materialize, the realization of ridiculously low dividend yields will sink in. Add to this ever more corporate profit disappointments, and you have the unmistakable makings of a bear market.

As to the violence of the crash, we expect a repeat of 1987, and for the very same reason — portfolio hedging against a fall. Once the outlook for stock prices appears precarious, there will be a rush for protection, mainly through over-the-counter derivatives provided by commercial and investment banks. But since every one will scramble for safety at the same time, it will prove about as efficacious as giving matches to a pyromaniac. Given today a $10 trillion capitalization, its implosive power is much worse than in 1987. And what will this do to the banks that make this market?

In contrast to 1987, a stock market crash will severely impact the U.S. economy. It will continue to demonstrate resilience only as long the equity markets perform well. The surprise will be the speed and the severity of the economy's response to a market accident. The U.S. economy has become hostage to the boom.■

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